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IN THE

Supreme Court of the United States

October Term, 1965

No. 140

ISADORE BLAU,

Petitioner,

vs.

DAVIS FACTOR, LOUIS FACTOR, MAX FACTOR, JR., SIDNEY FACTOR, CHESTER FIRESTEIN, MAX FIRESTEIN, FREDA F. SHORE, ANNA FACTOR, DORIS FACTOR, DOROTHY FACTOR, CECILIA FIRESTEIN, and MAX FACTOR & CO.,

Respondents.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

Reply Brief in Support of Petition for Certiorari.

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I.

The Respondents Effected a "Purchase" of Class A Shares on the Date They Exchanged Their Convertible Common Stock Therefor.

In paraphrasing the basic concept of the Court's opinion below, the respondents contend at page 11 of their brief that, since they had initially acquired their issuer's convertible Common shares "many years earlier", the date upon which they acquired *such* shares "should be treated as the purchase date" of the *Class A stock*

which they subsequently received in exchange therefor. Continuing this argument the respondents further urge that, since the sales of their *Class A stock* (concededly made *less than* six months subsequent to its acquisitions), were effected more than six months after they had purchased their *convertible Common shares,* "the making of the exchange, and its timing, were simply irrelevant to the use of insider information in short-term speculation" even "if respondents acted upon inside information in disposing of their (Class A) stock interest when they did."

Although conceding that the statutory definition of "purchase" *expressly includes* "any contract to buy, purchase, or otherwise acquire",[1] the respondents attempt to amplify their argument at page 14 of their brief by asserting that "there is no contract made at the time of the exchange"; and "the only contract to acquire (the Class A stock) was made when the (convertible) Common shares were purchased."

This argument is completely unsound, however, for the following reasons:

While it is true that the ownership of the issuer's convertible Common stock carried with it an *option* which granted the right *to ask for and receive* Class A shares in exchange therefor, such an option merely constituted an irrevocable *offer* by the issuer which could only ripen into a legally binding "contract" when *accepted and acted* upon by its owners. Obviously the issuer was not legally bound to issue its Class A stock in exchange for convertible Common *until such time* as

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[1]Section 3(a)(13) of the Securities Exchange Act of 1934, 15 U.S.C.A. Sec. 78(c)(13).

the respondents decided to exercise their option and request it, thereby converting such option into a valid contract.

By attributing the dates of their initial convertible Common stock purchases to their subsequent Class A acquisitions, respondents have failed to recognize the legal distinction between their former *executory rights* to acquire such Class A shares and their subsequent voluntary actions required to mature such rights into a valid and binding "contract" to acquire those securities.

The identical argument was raised in *Park & Tilford, Inc. v. Schulte* (2 C.A.), 160 F. 2d 984, where the Court brushed it aside with the observation (at p. 987) that

> "Defendants did not own the common stock in question before they exercised their option to convert; they did afterward. Therefore they acquired the stock within the meaning of the Act. The Act certainly applies as well to executed acquisitions as to executory contracts to acquire."

The same argument was also raised and answered in the same way in *B. T. Babbitt, Inc. v. Lachner* (2 C.A.), 332 F. 2d 255, at p. 258.[2]

The *rationale* in all these cases was based upon the proposition that when an insider converts one class of his issuer's stock into another, it is *his own voluntary action* in exercising his option to convert which determines the actual date of his acquisition of the security

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[2]To the same effect see also, *Heli-Coil Corp. v. Webster* (D.C. New Jersey 1965), 222 F. Supp. 831; *Petteys v. Northwest Airlines, Inc.* (D.C. Minnesota, Fourth Division). The opinion in this case, which was rendered on August 4, 1965, has not yet been reported.

received by the exchange. Accordingly, he may time the exercise of his option to give him the greatest leverage for using his inside information in short-term speculation, thus creating for himself the very opportunity which the statute was designed to correct.

II.

Economic Equivalence of Two Separate Classes of Stock Is Completely Immaterial to Any Determination of the Statutory "Purchase".

The respondents argue at page 15 of their brief that "Basically, no *purchase* takes place if the shares exchanged are the economic equivalents of each other."

This argument is unsound for the following reasons:

Firstly, the provisions of Section 16(b) of the Act fails to make any such distinction since obviously the same avenues for utilizing inside information are equally available to the insider in either instance, and he may time his conversion to make the best use of such information in any case.

Obviously, "economic equivalence" can hardly form the true and determinative test for the statutory "purchase" because in almost every instance, where a convertible security may be exchanged into another class of stock, the market price of the former will normally tend to be tied to and the economic equivalent of the latter. Unless that were so, it would hardly ever be worth while for a shareholder to exercise his conversion privilege.

Secondly, since the option to convert lies completely within the *voluntary* discretion of the owner of the con-

vertible security, his exercise of such right of conversion is no different than if he had purchased for cash in the open market the very security which he could acquire through his voluntary exercise of his conversion privilege. In fact, such an insider's acquisition through the latter means would afford him an even greater opportunity to misuse his inside information through short-term speculation than if he had to effect such purchase for cash because he has not increased his original investment risk until he is sure that it is safe and profitable to do so.

Although the respondents seek to minimize the substantial difference between the convertible Common and the Class A stock, as owners of the convertible security their right to payment of dividends thereon was *legally limited* by express provisions of the issuer's Charter [R. 80]. And, while it is true that the conversion privilege gave them the right to *ultimately* attain the dividend preference of the Class A shares, the respondents' *affirmative action* in converting their Common shares was a necessary prerequisite therefor.

Moreover, it seems altogether preposterous to categorize the convertible Common and Class A stock as "equivalents" in view of the distinct intrinsic differences which would naturally affect the public marketability of each. For assuredly, any normal public investor would prefer to purchase a fully listed, dividend-preferred Class A security, rather than an unlisted, unregistered, limited-dividend convertible Common stock. And this would be true despite the fact that the convertible share were freely exchangeable into Class A stock.

Thus, it is wholly conceivable that a public investor might purchase the convertible security a day or two before the record date for the payment of dividends, and by the time he exercised his conversion privilege he would have lost his right to be paid the higher dividends of the Class A stock. Under such circumstances, he would hardly consider both classes of stock to be "economic equivalents".

Although the argument of "economic equivalence" has repeatedly been raised in other cases, the Courts have refused to be swayed thereby in determining the statutory "purchase".[3]

The respondents seem to argue at page 11 of their brief that their acquisitions of Class A shares ought not be construed a "purchase" under the statute because "the conversion worked no material change in (their) proportional equity ownership of the company".

The obvious inference from this argument is that there can *never* be a "purchase" from the exchange of one class of stock to another unless the insider acquires thereby some *additional* proportional equity interest in the issuer.

The identical argument, however, was rejected in *Roberts v. Eaton* (2 C.A.), 212 F. 2d 82, with the statement (at p. 86) that "we do not think it is alone enough to immunize the transaction from the applica-

[3]See, *Park & Tilford, Inc. v. Schulte* (2 C.A.), *supra; B. T. Babbitt v. Lachner* (2 C.A.), *supra; Heli-Coil Corp. v. Webster, supra; Petteys v. Northwest Airlines, Inc., supra.*

tion of the statute". The Court similarly rejected such argument in *Blau v. Mission Corp.* (2 C.A.), 212 F. 2d 77, cert. denied, 347 U.S. 1016.

The respondents present a further argument at page 13 of their brief, that

> "The two-class structure here involved is no different than one in which there is only one class of stock and some of the shareholders have given the corporation a waiver of dividends * * * which waiver is revocable by the shareholder at any time."

They conclude from this erroneous premise that their act in exchanging the convertible Common for Class A stock merely terminated their "pre-existing contingent waiver of dividends" and, therefore, "is not a *purchase.*"

This argument hardly merits consideration because it is so obviously unsound. If the respondents' arguments were correct, there could never be a "purchase" where the insider exchanged *any* convertible security of his issuer, whether the convertible security paid greater or lesser dividends than the stock into which it were exchangeable. For, in each instance the insider would contend that his act of exchanging his convertible security merely terminated his "pre-existing contingent waiver" with respect to the amount of dividends payable to him by the issuer.

III.

The Question of Federal Law Presented Herein Affects the Rights of Management and Stockholders of Thousands of Public Corporations.

The importance of the issue presented herein is of *continuing* concern to the investment community throughout this land, and is not, as the respondents seem to suggest, limited to the facts in this case.

Moreover its significance has been greatly amplified in view of the recently enacted legislation which has brought thousands of additional *unlisted* public corporations, having outstanding convertible securities, within the purview of Section 16(b) of the Securities Exchange Act of 1934.[4] For, unless the problem here presented is finally determined by this Court the statute will completely lose its effectiveness in the area most subject to abuse, because the courts in the various Circuits will continue to render different opinions in the same situations dependent upon whether their interpretations of the statute are strict or liberal. Such a chaotic condition in this important field of public legislation should not be permitted to exist any longer.

Conclusion.

For the reasons stated above, and in the petition for certiorari, petitioner prays that the petition for certiorari be granted.

Respectfully submitted,

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[4]Secs. 12(g) and 16(a), Securities Exchange Act of 1934, as amended in 1964; 15 U.S.C.A. Secs. 78L(g) and 78p(a).